

must do their own valuations; they may use their own professionals, if they feel the need, but the buyers control the professionals. Moreover, they can reverse the tactics: "My professional says your professional is in error. The business is worth only...." This tactic is a part of the negotiating process.

Conclusion

Four methods of valuing a business have been discussed: market value of net assets; value of future earnings; off balance sheet valuations; and replacement cost. These methods can be used by both buyers and sellers to determine the value of a business. However, this is just the starting point. Once the facts have been reasonably ascertained, the negotiations begin. Much depends on the deal-making skills of the parties. There are hundreds of ways to put together a deal. The art is finding one that gives both parties what they want.

Once a deal is cut, the professionals take over to formalize it to the satisfaction of the IRS, the attorneys, and all other parties involved with the transactions.

The Art Gallery

A consulting client wanted to establish a favorable selling price for his art gallery in Carmel, California. The client needed to obtain a certain price for the gallery in order to retire. Using the four methods of business valuation yielded the following results.

Market value of net assets. Inventory for the art gallery was on consignment from the artist; therefore, there was no inventory value. The accounts receivable were secured by major credit cards. The fixtures in the gallery amounted to wall space and a few pedestals for sculptures. The building was rented under a 10-year lease. All together, the gallery's asset value minus its accounts payable showed a small net worth. Clearly, the seller would never want to establish the art gallery's sale price using the asset valuation method. The buyer, on the other hand, would certainly prefer to use this method.

The value of future earnings. The art gallery was formed as a sole proprietorship, and the owner took most of the excess cash flow as salary and benefits. The multiple of cash flow—three times for a cash payment and five to seven times for term sale—still left the selling price on the low side, though higher than the asset valuation method. This result still benefited the buyer far more than the seller.

Replacement cost. Starting up a gallery is not very expensive because inventory is on consignment, accounts receivable are on credit cards, and the fixtures and build-out expenses are minimal. Again, this method favors the buyer over the seller.

Off balance sheet valuation. The gallery had many valuable off balance sheet assets. The gallery had a permit to operate in Carmel, which had instituted a moratorium on all further licenses for art galleries within city limits. The gallery had been in business for 20 years and had established a list of wealthy clients and art buyers from all over the world. The gallery's 10-year lease secured a prime location that included heavy street traffic. The salespeople were well trained and exhibited a proven understanding of customers' needs and expectations. In addition, the gallery maintained exclusive rights to the sale of all the works produced by six of the most famous artists in Carmel. The customer service and connections the gallery had maintained for 20 years had earned the business a high level of positive name recognition. The off balance sheet method established a much higher value.

The art gallery owner then set up a five-year plan to build his off balance sheet through other intangible assets because this method will allow him to meet his retirement goals. All entrepreneurs should go through this valuation process to determine which method will work best for them as they plan for a high-priced exit. Entrepreneurs considering new concepts should always look at starting a business that can end up with a potentially high selling price.